

Four Top Passive Funds, Plus a Correction

Tracking Morningstar Analyst Ratings | Russel Kinnel

What Are Morningstar Analyst Ratings?

Our ratings are chosen for long-term success. Analysts assess a fund's competitive advantages by analyzing people, process, parent, performance, and price. They do rigorous analysis and then submit their ratings to a committee that vets their work for thoroughness and consistency.

Error in Past-Performance Calculations

We found a programming error that resulted in incorrect past-performance batting averages for funds with Morningstar Analyst Ratings of Gold for July, August, and September. Most of the errors understated our batting averages. We have printed the corrected figures for those months on the facing page along with the latest figures through November. We regret the error.

Four Passive Funds to Rule Them All

There are ways to buy combinations of indexes, but many investors would rather have a little more control over their holdings. With that in mind, I have chosen four of the best passive funds, so you can dial in your own weightings over time. Three of the four are also available in exchange-traded fund form.

Vanguard Total Stock Market Index VTSAX is a logical starting point given its tiny costs and very wide reach. For just 0.05%, you tap the entire U.S. stock market. It's logical that this fund would become the largest fund in the world as there is enormous capacity for a wide-ranging index fund like this one. Running a huge market-cap-weighted index has only required single-digit levels of turnover. In addition, Vanguard has an unmatched pedigree in the realm of index funds. Rock-bottom fees, broad exposure, and a solid parent—that's why this fund has an Analyst Rating of Gold.

DFA US Micro Cap DFSCX gets you exposure to the one part of the U.S. equity market that Vanguard Total Stock Market doesn't hit. Micro-cap land is really DFA's bailiwick. DFA has turned the trading of micro-cap stocks into a science—making their illiquidity work to the firm's advantage. Simply indexing micro-caps would be too costly because you'd end up making a lot of small trades in stocks that have big bid-ask spreads.

DFA has the flexibility to stray slightly from its benchmark and be opportunistic with its trades. The firm aims to be a provider of liquidity. That's industry jargon for selling the stocks that someone's eager to buy and buying those with eager sellers. That allows DFA to capture that bid-ask spread rather than pay it. As a result, DFA has a real edge over pure index funds in micro-cap land. By some estimates, the firm actually makes money with its trades. At the very least, it seems to pay less than its peers, and that shows up in superior returns. We rate the fund Gold.

Vanguard Emerging Markets Stock Index VEMAX brings indexing to a part of the investing world where actively managed strategies are the norm. The good thing about that is this fund's expense-ratio edge versus actively managed funds is even greater than you'd see in developed markets. The fund charges just 0.18% in expenses compared with an average of 1.62% for all funds in the category.

Vanguard Tax-Managed International VTMGX is a good way to get exposure to the developed foreign markets, and that's what you'll want if you are buying an emerging-markets fund separately. First, let's clear up some confusion. **Vanguard Developed Markets Index VDMAX** is going to merge into this fund next year. The two are very similar. Vanguard Tax-Managed International officially can differ from its index in order to reduce the fund's tax bill, while Vanguard Developed Markets Index can't. However, Vanguard has decided that it doesn't need the added flexibility, and therefore the two funds can merge.

While Vanguard Tax-Managed International is technically the survivor, the fund will be renamed Vanguard Developed Markets Index and it will be run in a manner similar to the current Vanguard Developed Markets Index. In the meantime, Vanguard Developed Markets Index is closed to new investors and the firm is steering people to the surviving fund. The important thing is you are getting broad exposure to foreign markets for just 0.10% in fees. We rate it Gold. ■

Board	Meeting Date	Item #
DCIC	2.13.14	5C